## Office of Chief Counsel Internal Revenue Service

### memorandum

CC:LM:MCT:CIN:2:TL-N-6203-00

GRShuler

date:

to: Sidney Saewitz, Team Manager, LM:RFP:1521:GP

Cincinnati, Ohio

from: Associate Area Counsel (LMSB), Cincinnati

subject:

EIN:

Advisory Opinion on Bad Debt

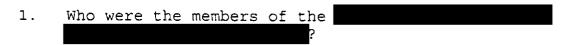
#### DISCLOSURE STATEMENT

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By a memorandum dated October 24, 2000 that was supplemented by additional information on December 11, 2000, you requested assistance on several issues relating to

#### ISSUES



- 2. Were the transfers of funds from

  to

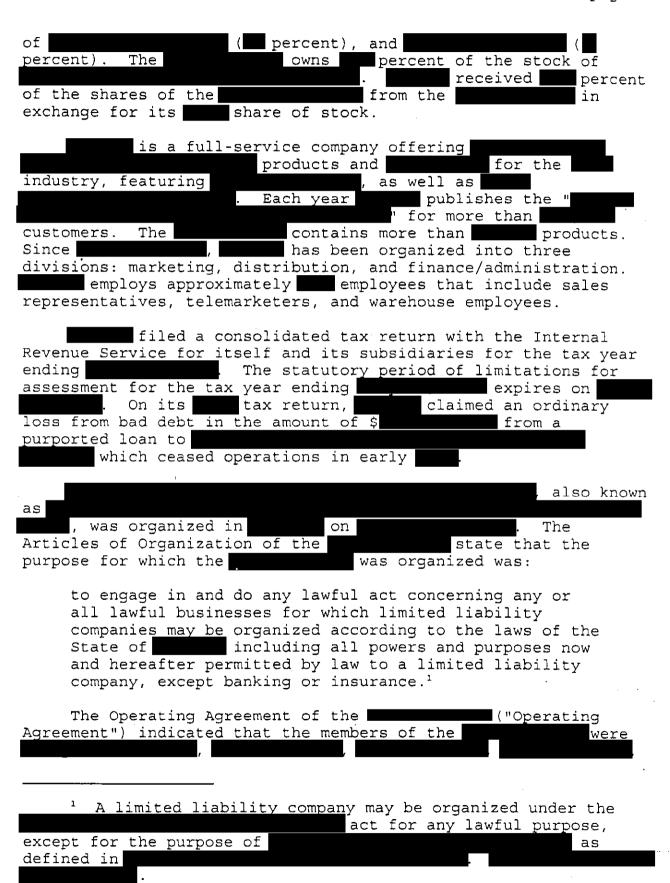
  with whom it had no business relationship other than common shareholders, contributions to capital rather than business loans?
- 3. Did the common shareholders of and receive constructive dividends from as a result of the transfers of funds?

#### CONCLUSIONS

- 1. The members of the are those individuals that signed the Operating Agreement.
- 2. Yes. Based on the facts provided, the transfers of funds from to were contributions to capital.
- Yes. Based on the facts provided, the common shareholders of and received constructive dividends from as a result of the transfers of funds.

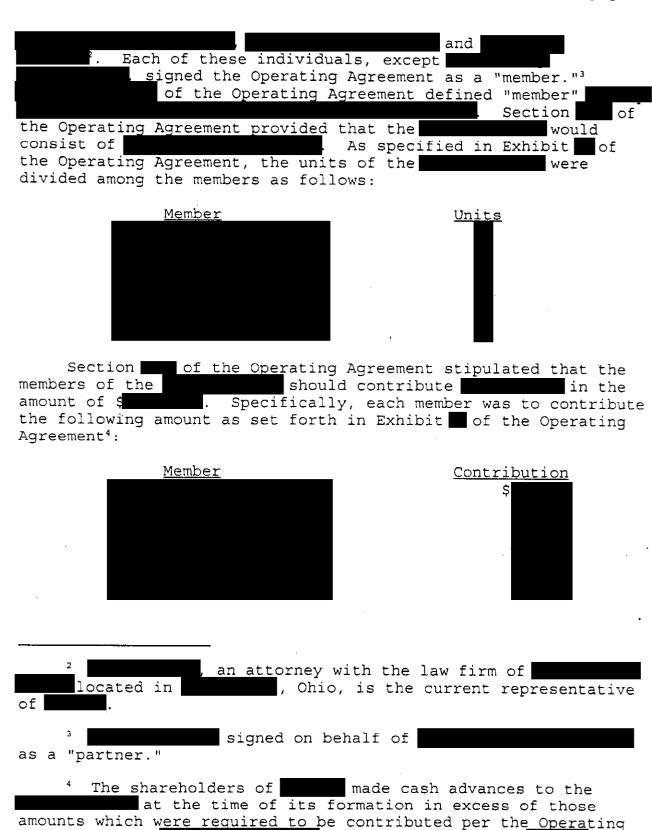
#### **FACTS**

The facts as we understand them follow: In,
, began operating the as a sole
proprietorship. The was incorporated on
. In the 's and 's, 's,
family joined the business.
, and , became
involved in the business and took over ownership after
in .
In percent of the stock of the was
transferred to the The
income beneficiaries of the are
percent), ( percent),
nercent) the (percent) the



Agreement. On

caused



, the shareholders of

to transfer the amount of \$ to the

The financial statements of the indicate that the members' capital accounts were in the amounts of \$2 and \$4. The statements do not provide a specific breakdown of each member's capital account.

For the taxable years ending and filed Forms 1065, U.S. Partnership Return of Income, with the Internal Revenue Service. The principal business activity of the that was listed on the forms was real estate development. The members' percentage of profit and loss sharing listed on the Schedules K-1 corresponded to the member's ownership of the as reflected in the Operating Agreement<sup>5</sup>. Schedule M-2 of the initial return for the taxable year indicates that there was no capital contributed to the Schedules K-1, each member's capital account at the beginning and ending of the year had balances.

On Schedule M-2 of the Form 1065 filed by the for the taxable year ending the the reported a beginning balance in the amount of \$ well as capital contributions in the amount of \$ during the tax year. The Schedules K-1 for members and indicate that those members had capital accounts at the beginning and ending of the year with balances. The Schedule K-1 for indicates that he had a capital account with a balance in the amount of \$ at the beginning of the year. The balance of the capital account of was was offset by losses in the amount of \$ resulting in a capital account with a at the end of the year. The Schedule K-1 for indicates that he had a capital account with a balance of the beginning of the year and contributed capital in the amount of \$1, ... during the year. The balance of the capital account of was offset by losses in the amount of resulting in a capital account with a balance at the end of the year.

<sup>&</sup>lt;sup>5</sup> Section of the Operating Agreement required that each member's distributive share of all tax related items, including

The signed a promissory note to in the amount of "\$ or so much thereof as may be advanced and outstanding pursuant to any advances made by the Lender [ ] to the Company [the according to the grid annexed hereto." The note was dated and transferred funds to the in the amount of \$ as indicated on the annexed grid attached to the promissory note.
The promissory note was a demand promissory note with a stated interest rate corresponding to the applicable Federal rate. The promissory note had no fixed maturity date and no demand was made on the note. The promissory note was not secured by any assets of the did not require the individual members of the did not require the promissory note and no guaranty was given by the members of the promissory note and no guaranty was given by the members of the repayment schedule for interest and principal and no such repayment was made by the formulation for the financial statement of did not record this journal entry for book purposes until the end of tax year when it was written-off as a part of the note balance in a claimed bad debt deduction. The did did not accrue or pay any interest expenses on the promissory note for book or tax purposes.
The transferred the funds it received from
was a Florida Limited Partnership which was formed on Article , Section of the Limited  Partnership Agreement for indicated that the partnership was formed "
real property <sup>8</sup>
<sup>6</sup> The had no assets or sources of revenue.
<sup>7</sup> Section of the Operating Agreement provides that no members shall be liable for the liabilities of the

located in, Florida. The signed a "Contract for Purchase and Sale of Property" for this real property. Before the contract would become effective and bind the parties, the had to pre-sale at least condominium units which were to be built on the real property.
The partners of were the (a general partner) and (a limited partner). Article Section of the Limited Partnership Agreement provided that the initial capital of was specified in Exhibit of the which was a general partner of had a interest in the partnership in exchange for a capital contribution in the amount of \$ 1.
The financial statements of indicate that the partners' capital accounts were in the amounts of \$ and
For the taxable years ending  filed Forms 1065, U.S. Partnership Return of Income, with the Internal Revenue Service. The principal business activity of that was listed on the forms was real estate development. Schedule M-2 of the initial return for for the taxable year indicated that there was capital contributed to during the taxable year in the amount of \$ The Schedule K-1 for the indicated a capital account with a beginning and ending balance of during the tax year. The Schedule K-1 for indicated that he made a contribution of capital during the tax year in the amount of \$ The Schedule K-1 for
On Schedule M-2 of the Form 1065 filed by for the taxable year ending reported a beginning balance of \$ at the beginning of the year, as well as a net loss per its books in the amount of \$
9 Article , Section of the Limited Partnership Agreement provided that partner's percentage of interests in did not have any relationship to their respective capital contributions to

signed a promissory note to the in the amount of "\$ , or so much thereof as may be advanced and outstanding pursuant to any advances made by the Lender [the to the Partnership [ according to the grid annexed hereto." The note was dated

Between and transferred funds to in the amount of as indicated on the annexed grid attached to the promissory note.

The promissory note was a demand promissory note with a stated interest rate corresponding to the applicable Federal rate. The promissory note had no fixed maturity date and no demand was made on the note. The promissory note was not secured by any assets of \_\_\_\_\_\_\_. The \_\_\_\_\_\_\_ did not require the individual partners of \_\_\_\_\_\_\_ to personally guaranty the promissory note and no guaranty was given by the partners of \_\_\_\_\_\_\_. There is no evidence that the

The method of allocating the loss was clearly contrary to the Limited Partnership Agreement. Article Section of the Limited Partnership Agreement provided that the profits, losses, deductions and credits of were to be allocated in accordance with each partner's respective percentage interest.

Article Section of the Limited Partnership
Agreement provided that a general partner would not be liable for
the liabilities of Article Section of the
Limited Partnership Agreement provided that limited partners
would not be liable for the liabilities of but could
elect to be personally liable for any debt incurred by

established a	repayment sc	hedule for	intere	est and p	principal	and
no such repayı	ment was made	by			did no	ot
accrue or pay		expenses	on the	promisso	ory note f	For
book or tax pi	urposes.					

The transferred funds from the were used by to pay for its operating expenses including professional fees for site plans, construction drawings, environmental assessments, surveying, marketing studies, and for expenses of the sales staff. These expenses were incurred in connection with the marketing of a real estate project in Florida known as the

The was an condominium project. The was , Florida in that it intended to provide to each condo unit rather than an entrance or entry fee program. The community would have consisted of condominiums ranging from one to three bedrooms, a square foot clubhouse, and an unit assisted living facility. The intended to offer its residents services including, but not limited to, dining, transportation, activities, and security. The amenities to be offered to the residents would have been comparable to other communities in , Florida.

was to be built on acres of property in , Florida for which the had signed a "Contract for Purchase and Sale of Property." The contract to purchase the land expired on L<sup>13</sup> Construction of the condominium units was to start in the obtained conditional financing from an Ohio corporation. As a condition in making the loans, had to sell required that condominium units in intended to obtain a revolving construction loan to fund the condominium units and clubhouse and a construction term loan to fund the assisted living facility. The funding was to be provided in phases with each phase consisting of the construction of condominium units. also solicited additional partners to provide equity for its operation by offering a let under in the

indicated that "funding to date has been provided by "."

The failed to purchase the property.

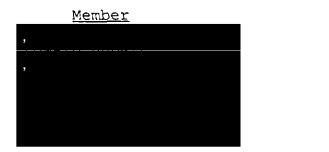
also failed to sell condominium units in the by the condominium units in the condominium units i
funds to Due to a lack of funds, the construction of the failed.14
The assets of were liquidated and generated the amount of \$ . Upon the liquidation of the assets, applied the amount of \$ . To its promissory note with the reported the remaining balance of the note as income from forgiveness of debt. The applied the amount of \$ . To its promissory note with reported the remaining balance of the note as income from forgiveness of debt. The also claimed an ordinary loss from bad debt in the amount of \$ . On its tax return for the tax year ending to the amount of \$ . To its tax return the tax year ending to the amount of \$ . The claimed an ordinary loss from a bad debt in the amount of \$ . The claimed an ordinary loss from a bad debt in the amount of \$ . The claimed an ordinary loss from a bad debt in the amount of \$ . The claimed an ordinary loss from a bad debt in the amount of \$ . The claimed an ordinary loss from a bad debt in the amount of \$ . The claimed an ordinary loss from a bad debt in the amount of \$ . The claimed an ordinary loss from a bad debt in the amount of \$ . The claimed an ordinary loss from a bad debt in the amount of \$ . The claimed an ordinary loss from a bad debt in the amount of \$ . The claimed an ordinary loss from a bad debt in the amount of \$ . The claimed an ordinary loss from a bad debt in the amount of \$ . The claimed an ordinary loss from a bad debt in the amount of \$ . The claimed an ordinary loss from a bad debt in the amount of \$ . The claimed an ordinary loss from the note with the claimed an ordinary loss from the note with the claimed an ordinary loss from the note with the claimed an ordinary loss from the note with the claimed an ordinary loss from the note with the claimed an ordinary loss from the note with the claimed an ordinary loss from the note with the claimed an ordinary loss from the note with the claimed an ordinary loss from the note with the claimed an ordinary loss from the note with the claimed an ordinary loss from the note with the claimed an ordinary loss from the note with the claimed an ordinary loss from the note with t
ANALYSIS
I. MEMBERS OF THE
Under the Limited Liability Company act, a member's interest in a limited liability company ("LLC") consists of economic and non-economic interests. One interest is a member's capital contribution, which a member may withdraw under certain conditions.  also generally has the right to receive profits.  15 A member's interest also usually grants him
Despite s failure to obtain financing for the the project, after the amount of \$ to \$ in accordance with the purported promissory note dated
which controls division of profits, envisions withdrawal of capital contribution without dissociation: "  This quoted material clearly contemplates a situation where a member has withdrawn some (or even all) of his capital
contribution but has not dissociated as a member.

This case was the

opportunity to interpret the LLC act.

the ability to participate in management. . Overall, a member's interest is transferable, although the management rights of a transferee may be limited. requires that the articles of organization of an LLC set forth the total amount of cash and a description and agreed value of property other than cash to be contributed to the LLC. The contributions to capital of a member to the limited liability company may consist of cash or other property, promissory notes or services rendered or to be rendered. law does not ١. specifically require capital contributions in order to be a member of an LLC. When there is a change in the amount or the character of the contributions to capital, requires an amendment to an LLC's articles of organization when the amount or character of contributions changes. While the statutory provisions provide some guidance regarding a member's interest, there is little case law regarding a member's interest in an LLC. 16 In addition to the above statutory provisions, the courts of focus on an LLC's operating agreement and articles of organization. Section of the Articles of Organization of the provided that the total amount of cash contributed to the LLC was to be \$ \_\_\_\_\_. There is no other description in the Articles of Organization of other property that was to be contributed to the LLC. Section of the Articles of Organization entitled " provided that " Section of the Operating Agreement of the defined "member" as any person who has signed the Operating Agreement as a member. The Operating Agreement was signed by and "members." Section of the Operating Agreement provided that

the would consist of membership units, the units were divided among the members as follows:





Section of the Operating Agreement provided that the members of the would make a total cash contribution of \$ \_\_\_\_\_\_. Specially, each member was to contribute the following amount as set forth in Exhibit of the Operating Agreement:





The representative of now claims the individuals who signed the Operating Agreement were not members of the because they never contributed the capital as required in the Operating Agreement. The shareholders of made cash advances to the at the time of its formation in excess of these amounts through their corporation as well as made subsequent transfers through to the It is not known whether any services or other property were contributed to the by its members.

The individuals who signed the Operating Agreement also continued to conduct business and manage the business affairs of the sa if they were members including receiving funds from in accordance with a purported promissory note and transferring funds to in accordance with a purported promissory note. The tax returns filed by the also included Schedules K-1 for the individuals who signed the operating agreement. Furthermore, no amendment to the Articles of Organization of the was filed with the Secretary of State of to change the amount or character of the contributions required in the articles of organization.

Under Section of the Operating Agreement, any member of the could have been expelled from the LLC if the member committed a breach of a material provision of the Operating Agreement. None of the individuals who signed the Operating Agreement was expelled from the LLC. Nor was any legal action pursued to compel members to make contributions in conformity with the Operating Agreement. Consequently, the individuals who signed the Operating Agreement were members of the

#### II. FUNDS TRANSFERRED BY

There are significant tax advantages to classifying a transfer of funds to a pass-through entity as "debt" rather than "equity." Most pertinent to this case, an investment classified as "debt" may give rise to a "bad debt" ordinary loss, while worthless capital contributions would only be treated as a capital loss.

Determining whether advances made by a corporation are bona fide loans depends upon whether, at the time the advances are made, (1) there was a genuine intention to create a debt, (2) there was a reasonable expectation of repayment, (3) the intention to create a debt comported with the economic reality of creating a debtor-creditor relationship, and (4) an unrelated lender would have advanced money to the transferee in the same amount and on the same terms. Litton Business Systems v. Commissioner, 61 T.C. 367, 377-381 (1973), acq., 1974-2 C.B. 3.

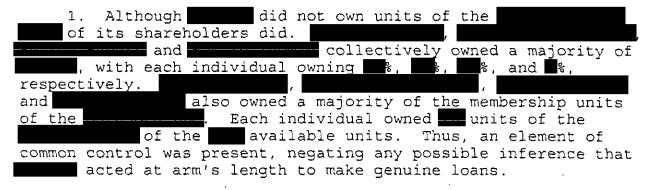
#### A. HAD NO INTENTION TO CREATE A DEBT

In determining whether the transactions constituted bona fide loans, the intent of the parties is important. Donisi V. Commissioner, 405 F.2d 481, 483 (6th Cir. 1968). However, declarations of the parties that they intend a transaction to constitute a loan "are insufficient if [the transaction] fails to meet more reliable indicia of debt which indicate the intrinsic economic nature of the transaction." Berthhold v. Commissioner, 404 F.2d 119, 122 (6th Cir. 1968).

The courts have identified and used numerous factors as aids in deciding the intent question, including: (1) the extent to which the related borrower controls the entity; (2) the earnings and dividend history of the corporation; (3) the magnitude of the advances; (4) whether a ceiling exists to limit the amount the

Under the Operating Agreement, the member had days from date of notice to correct such a breach.

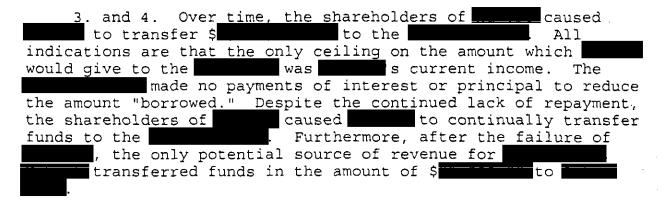
corporation advanced; (5) whether or not security is given for the advance; (6) whether there is a fixed maturity date; (7) whether the corporation undertakes to force repayment; (8) whether the borrower is in a position to pay; (9) whether the related borrower attempts to repay; (10) whether interest is charged by the corporation; (11) whether a certificate of indebtedness is given to the borrowing entity; (12) whether the terms of an agreement between the corporation and the related borrower establish an absolute and unconditional duty to repay; (13) whether the advances are proportionate to the related borrower's stock ownership; (14) the source of payments; (15) thin or adequate capitalization; (16) the ability of the corporation to obtain loans from outside sources; (17) the uses to which the advances were put; (18) the failure of the debtor to repay; (19) the risk involved in making the advance; and (20) the payment of interest only out of "dividend" money. 18 In your case, the great weight of the evidence on virtually all of these factors points away from intent to create a debt.



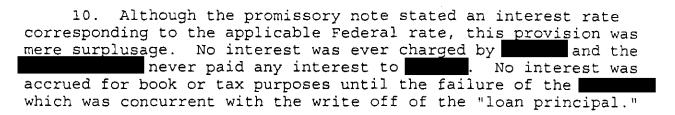
2. is a profitable corporation which has only declared a single dividend in its corporate existence. In a dividend was declared to fund 's purchase of real property from its shareholders. The profit and could not make a profit unless the was

<sup>18</sup> See, e.g., Alterman Foods, Inc. v. United States, 505
F.2d 873 (5<sup>th</sup> Cir. 1974), aff'g 73-2 USTC ¶ 9792 (N.D. Ga. 1973);
Livernois Trust v. Commissioner, 433 F.2d 879 (6<sup>th</sup> Cir. 1970),
aff'g T.C. Memo. 1969-111; Estate of Chism v. Commissioner, 322
F.2d 956 (9<sup>th</sup> Cir. 1963), aff'g T.C. Memo. 1962-6; Oyster Shell
Products Corp. Inc. v. Commissioner, 313 F.2d 449 (2<sup>nd</sup> Cir.
1963), aff'g T.C. Memo. 1961-323; Kaplan v. Commissioner, 43 T.C.
580 (1965), acq., 1978-2 C.B. 2, nonacq., 1978-2 C.B. 3;
Hambuechen v. Commissioner, 43 T.C. 90 (1964); Roschuni v.
Commissioner, 29 T.C. 1193 (1958), acq., 1958-2 C.B. 7, aff'd per curiam, 271 F.2d 267 (5<sup>th</sup> Cir. 1959), cert. denied, 362 U.S. 988 (1960); Shea v. United States, 83-1 USTC ¶ 9115 (N.D. Ala. 1982).

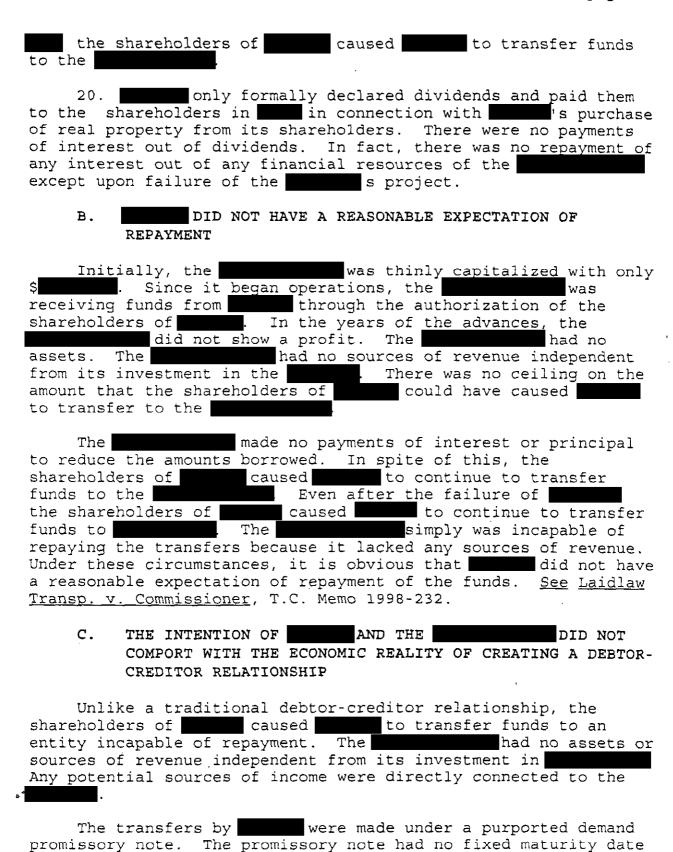
successful. With ready cash reserves, the shareholders of could, and did, use to finance its shareholders' investment in the without formally declaring dividends.



- did not demand personal guaranties from the members of the and no guaranties were made. In the did not require the to provide any security for the transfer of funds and received no security for the transfers. This laissez-faire approach was in marked contrast to the usual way loans are made and secured in the banking business.
- 6. The promissory note that the executed was a demand promissory note. However, the note had no fixed maturity date. There was no schedule for repayment of interest or principal on the promissory note. Not surprisingly, there was no repayment.
- 7. The shareholders of never caused to undertake procedures to force repayment of principal or interest on the promissory note signed by the No demand for payment was ever made by
- 8. The was never in a position to repay any amount. The had no assets or sources of revenue. It established no credit elsewhere. The only possibility that the had for generating income was dependent on its investment in the term. Even after the failure of the shareholders of caused to continue to transfer funds to
- 9. The never established a fund to pay off the loan interest and principal, or had a plan to do so. Likewise, there is no indication that the ever attempted to repay the amounts received.



- 11. and 12. On its face, the promissory note seemed genuine. However, the financial condition of the the inside knowledge of as to the financial condition of the and the lack of security all combine to point to an obvious conclusion: There was no absolute and unconditional duty on the part of the to repay
- 13. The advances made to the were not proportionate to its ownership in the did not own any membership units of the
- 14. With its cash reserves from earnings, was able to, and did, transfer funds to the
- 16. The never attempted to borrow any funds from a non-related third party. Because of its financial situation, it is doubtful that a non-related third party would have loaned money to the without some guaranty or personal liability of the members.
- to invest in transferred funds to pay for its operating expenses including professional fees for site plans, construction drawings, environmental assessments, surveying, marketing studies and for expenses of the sales staff.
- 18. The lack of intent of the parties to treat the transfers as bona fide loans is also manifested by the lack of repayment. The failed to repay any interest or principal of the amounts that were transferred by
- 19. There was great risk to in making the advances to the had inside knowledge of the financial condition of the had inside knowledge of the thinly capitalized, lacked any source of income and had no assets. In spite of the financial predicament of the



and no demand was made on the note. The promissory note was not

secured by an assets of the . The shareholders of
did not require that have the individual members of
the personally guaranty the promissory note. No
guaranty was given by the members of the There is
no evidence that established a repayment schedule for
interest and principal and no such repayment was made by the
. The lack of intent of the parties to treat the
transfers as bona fide loans is also manifested by the failure of
to accrue interest expenses on its books until they
decided to write-off the "loan principal."

D. AN UNRELATED LENDER WOULD NOT HAVE ADVANCED MONEY TO THE THE IN THE SAME AMOUNT AND ON THE SAME TERMS AS

An unrelated lender would not have transferred funds to the on the same terms and conditions that the shareholders of caused to transfer the funds to the was organized on The with initial capital contributions in the amount of \$ had no other assets. The promissory note to but the shareholders of did not require that compel the to pledge any security for the funds received and the pledge any security. did not demand that the members of the personally guaranty the promissory note and members of the did not personally guaranty the promissory note. failed to have the establish a repayment schedule for interest and principal for the funds that the shareholders of caused to be transferred to continued to transfer funds to the the even though the never made any repayment of interest or principal on the promissory note. Transfers of funds were even made after the failure of the only potential source of income for the on these facts, an unrelated lender would not have loaned money to the on the same generous terms and conditions that the shareholders of caused to transfer funds to the

The attempt of to obtain financing from an unrelated lender is a comparable situation. Although the specific terms and conditions of the financing are not known, the unrelated commercial lender would not have loaned money to the limited partnership which had no assets or sources of revenues until a specific number of condominiums were pre-sold. Because the minimum sales requirement was not met, the unrelated commercial lender did not make the loans to

# III. IN REALITY THE TRANSFERS FROM TO THE WERE CONSTRUCTIVE DIVIDENDS TO THE COMMON SHAREHOLDERS OF AND THE

Under I.R.C. §§ 301 and 316, dividends to a shareholder must be included in gross income. Usually, when a corporation makes distributions of property to its shareholders with respect to its stock, out of accumulated or current earnings and profits, it formally declares dividends and pays them to the shareholders. Not all dividends follow that pattern. See, e.g., Radnay v. Commissioner, T.C. Memo. 1989-237 (holding that a shareholder received a dividend when corporation paid his entertainment expenses), aff'd without opinion, 921 F.2d 285 (11th Cir. 1990); Finney v. Commissioner, T.C. Memo. 1980-23 (holding that corporate payments of officers' personal and living expenses were dividends to the officers). It is well established that distributions by a corporation will be treated as a dividend to the shareholder if the distributions are made for the shareholder's personal benefit. See J.F. Stevenhagen Co. v. Commissioner, T.C. Memo. 1975-198, aff'd, 551 F.2d 106 (6th Cir. 1977).

The Tax Court has even held that the transfer of funds from one corporation to another entity, both wholly owned by the same shareholders, may result in a constructive dividend to the common shareholders where the advance constitutes contribution to capital, not bona fide debt. See Shedd v. Commissioner, T.C. Memo. 2000-292; Davis v. Commissioner, T.C. Memo 1995-283.

The courts apply a two-prong test to determine whether the transfers result in constructive dividends. Sammons v.

Commissioner, 472 F.2d 449, 451 (5th Cir. 1972), aff'g in part, rev'g in part, T.C. Memo. 1971-145. Under the first prong, an objective test, the court ascertains whether the shareholder exercised control over the transferred funds. Under the second prong, a subjective test, the court ascertains whether the primary purpose of the transfer was to benefit the common shareholder. See, e.g., Wilkof v. Commissioner, T.C. Memo. 1978-496, at 1851-38, aff'd per curiam, 636 F.2d 1139 (6th Cir. 1981); McLemore v. Commissioner, T.C. Memo. 1973-59, aff'd, 494 F.2d 1350 (6th Cir. 1974).

Under the corporation to entity fact pattern, the transferred funds are first considered distributed from the transferor corporation to the common shareholder, and the shareholder is then considered to have contributed the funds to the transferee entity's capital. Sammons, at 453. The facts in this case indicate that and the shareholders of should also be treated in this manner.

held a majority of the stock in seach owning s, %, %, and %, respectively.  and also owned a majority of the membership units of the seach individual owned membership units of the available units. The shareholders of caused to transfer \$ to the seach owned and then clearly exercised control.
The advances from to the were for the daily operating expenses of which the had invested in. had no equity in the did not transfer the funds in anticipation of selling products to the had no business relationship with the other than common shareholders. The facts fail to disclose a business purpose for the transfers.
In addition,  and  were able to use the funds of operate the  and  without using their own personal resources. By causing  to transfer funds to the  and  were able to carry on a business with extremely thin capitalization without having their personal funds subordinated to the substantial indebtedness of the transferee  LLC. These benefits were direct, not derivative. Consequently, there was no satisfactory primary business purpose for the transfers other than supplying a large amount of risk capital to an entity wholly unrelated in function and operation to the transferor corporation.
This memorandum is subject to post-review by the Office of Chief Counsel, under CCDM (35)3(19)4. We will inform you of any modification of this advice.
If you have any questions, please contact the undersigned at
MATTHEW J. FRITZ Associate Area Counsel

By:

GARY R. SHULER, JR.

Attorney (LMSB)

(Large and Mid-Size Business)